



**Comments for IRS Hearing on Improving the APA Program
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First, we want to thank the IRS Chief Counsel's Office for making it possible to offer suggestions at today's hearing.

My name is Michael Durst and I am a Principal with the accounting firm of PricewaterhouseCoopers. I am here today with my colleague, Richard Barrett, who also is a Principal with PricewaterhouseCoopers. In our work, we provide transfer pricing consulting services to multinational corporations, including providing representation before the Advance Pricing Agreement Program. Both of us have served as Director of the APA program, I from 1994 to 1997, and Rich Barrett from 1997 to 1999 after first having served as Deputy Director.

We are both speaking today to demonstrate our personal commitments, as well as that of our firm, to providing suggestions that we hope will contribute to the continued growth and improvement of the APA Program. Our comments today are based on our experiences as private practitioners and on advice from our colleagues at PwC, as well as our experiences as Directors of the APA program.

I would like today first to offer a very brief general observation. I then will address a technical question that the Chief Counsel's Office has raised in its announcement of these hearings; this question, while technical in nature, also leads naturally to a discussion of how the APA Program can better support tax administration generally. I would like next to offer some brief suggestions concerning the provision of information about APAs as well as about transfer pricing administration generally. Rich Barrett then will continue these comments concerning the provision of information, and will offer some suggestions concerning administrative aspects of the APA Program.

Both of us also will be pleased to address any questions that the Chief Counsel's Office thinks would be helpful.

At the outset, I want to express our view that the APA Program serves an important and constructive role in tax administration. Given the highly factual nature of the determinations that must be made under the transfer pricing laws, we believe it is important that taxpayers have a way of gaining reasonable certainty that they are complying with the rules in the view of the tax authorities. The APA Program has enabled our tax system to avoid numerous, costly disputes, including litigation. The APA Program provides valuable information to those in the government who seek to improve the transfer pricing regulations. More generally, the APA Program has been a pioneer within the IRS in up-front resolution of issues through cooperative processes. The APA Program has been conducted with a very high level of professionalism, and we think that all who have contributed to the development and operations of the APA Program should be proud of the work that they have done.

At the same time, the APA Program has now been in operation for well over ten years, and it is appropriate as part of good oversight practices that its processes be subject to a careful review, with an emphasis on ways by which the program can be improved. In fact, we think that continuous improvements can and should be made.

In approaching the question of how to improve the APA Program, it is useful first to focus on a technical question that the Chief Counsel's Office has raised in announcing these hearings. In Announcement 2004-98, the Chief Counsel's Office requests comment on "the impact that the execution of [an] APA may have on the relationship between the taxpayer and its related party." This question requires us to focus on an important substantive question that arises often in transfer pricing under applicable rules: namely, what are the relative risks and functions of the parties to controlled transactions? For example, does one party generally bear a large proportion of the overall business risks associated with controlled transactions, with the other party bearing relatively low risk – in which case a method such as the comparable profits method might be the best transfer

pricing method under the regulations? Or, alternatively, do the parties share risks relatively evenly, in which case another method, such as a profit split method, may be the best method?

For multinational groups formulating their transfer pricing policies, it is best practice for the parties to controlled transactions to memorialize in written agreements the manner in which the parties will be sharing risks, as well as the functional means by which the parties will ensure that the intended sharing of risks is accomplished. Such written agreements can in themselves remove some of the uncertainty surrounding transfer pricing. It is standard practice, in the due diligence segment of APA negotiations, for the government to determine the extent to which risks and functions have been divided between the parties by contract or, if contracts do not specify these points, whether the conduct of the parties over time has made their intent clear.

We believe that an APA agreement itself, by specifying the risks to be borne and functions to be performed by the parties to controlled transactions, can serve as a means of memorializing the intent of the parties concerning their respective functions and risks. Therefore, so long as the taxpayer conforms to the terms of the APA, including the allocation of functions and risks, the agreement can help provide assurance that the transfer pricing methodology that is agreed to in the APA remains appropriate. This is one of the ways in which APAs can contribute to effective tax administration.

Now, this very brief technical discussion, we hope, responds, albeit quite briefly, in a useful way to the technical question that Announcement 2004-98 raises, but we also think that discussion of this question leads naturally to discussion of a way in which the APA Program can be improved. We think that the government can do a better job of using the experience not only of the APA Program, but of transfer pricing administration generally within the IRS, to provide more detailed guidance concerning how the transfer pricing rules are being administered. For example, there is no reason why guidance could not explain how, using detailed hypothetical fact patterns that are based on actual

experience, the IRS in fact ascertains the parties' intentions concerning the allocation of functions and risks in realistic situations.

As one measure that we think would be especially useful, we recommend that the IRS engage in a comprehensive process of releasing more detailed information regarding the application of the transfer pricing regulations instead of only listing the transfer pricing methodologies used in APAs. A first step in releasing this information, while balancing the very important protection of confidential tax information of the companies participating in the APA process, should focus on the application by the IRS of the comparable profits method. The APA annual reports issued by the IRS demonstrate that the majority of the APAs completed use the CPM in establishing a best method to evaluate intercompany transactions. We would recommend that the IRS begin to include in the annual report the actual comparable companies used by the IRS within each SIC code. Information of this kind would pose no significant risk of disclosing taxpayer identities; although compiling and providing such information would require resources, we believe the usefulness of the public information provided, as well as the increase in confidence concerning the consistency with which the transfer pricing rules are being applied, would more than justify the cost. Such a process also would help demonstrate the feasibility of releasing additional information, ideally adding fairly rapidly to the extent of specific information that is provided each year.

We would like now to say a bit more about ways to use the APA Program, and other IRS procedures, in developing useful information on transfer pricing. To discuss this and offer other suggestions, let me now turn the podium over to Rich Barrett.

Thank you. Let me, as well, thank the IRS and its Chief Counsel's Office for making this forum available.

Ideally, the IRS would not limit its release of greater information concerning the administration of the transfer pricing rules to the APA annual report, or to information gathered only through the operation of the APA Program. The APA Program addresses

only a small number of the transfer pricing cases that the IRS resolves each year. A much greater number of cases are almost certainly resolved at the examination level, in Appeals, or in competent authority negotiations outside the APA Program. We believe a mechanism should be established within the IRS for experienced officials to gain an overview, periodically, of the resolutions that have been made throughout the IRS and to use this information to provide detailed guidance on the actual operation of the regulations within each of the industries of the LMSB unit. This information would supplement the relatively limited information that can be provided by the regulations, which necessarily, even in their examples, must be written at a high level of generalization.

Such guidance not only would assist taxpayers in complying with the law and enhance public confidence in transfer pricing administration. In addition, the process of compiling such guidance would help the Treasury and the Congress to identify any areas in which transfer pricing administration is posing difficulties, and in which regulatory or legislative improvements are warranted.

It is true that no two taxpayers' circumstances are likely to be entirely the same, but just as there are differences among all situations, there also often are similarities among different situations. Even given the inevitable variations among situations, information such as that suggested here should provide substantial assistance to both taxpayers and IRS examiners in addressing a variety of situations, within reasonable bands of tolerance, in a consistent and predictable manner. The availability of such guidance would add far more than it detracts from both predictability and fairness under the transfer pricing laws, and would make available important information that could be useful in improving applicable rules.

We should now move from the topic of information about transfer pricing to some specific suggestions concerning the APA process – first addressing the important topic of timeliness. Anyone who has participated in the APA process, in either the private sector or the government, is likely to feel frustration with the apparently slow pace of resolution.

Nevertheless, it is important to recognize that there are some inherent limitations to the speed with which most APAs can be concluded.

First, the transfer pricing law is, of course, highly factually dependent, and it is impossible for government personnel to evaluate and respond to taxpayer proposals without substantial expenditure of time in the review and analysis of financial data and other relevant facts. Moreover, responsible tax administration has always required, and continues to require, that the APA Program be subject to checks and balances. One means of providing such checks and balances, which the IRS has been careful to apply, is to require that IRS examiners with responsibility for the taxpayer, as well as APA and competent authority personnel, be actively involved in APA cases. This involvement of multiple functional areas of the IRS entails significant internal communication within the IRS, including internal debate. This process unavoidably, and appropriately, takes time.

We nevertheless think that, while maintaining the important checks and balances that are built into the APA Program, the staffing of many cases could be streamlined. In particular, in many cases it should be possible, while still ensuring a careful decision-making process, to avoid the duplication of technical personnel. For example, in many cases, an economist from the field or from the APA Office, but not both, probably could provide the necessary economic support. Similarly, a single attorney, from either the field or the APA Office, should suffice in most cases to provide the necessary legal involvement. There will be some large or especially difficult matters on which additional technical personnel will be required, but in many instances they will not, and in those instances personnel could be freed up to work on other matters, thus improving the timeliness and efficiency of the program.

An additional reason why many APAs require substantial time to complete is the need for agreement not only between the taxpayer and the IRS but also, in many cases, between the competent authorities of the United States and one or more other countries. The US competent authority and the competent authorities of other countries have achieved substantial improvements over the years in the efficiency of the competent

authority process, but the process is by its nature time-consuming. Resource constraints of more than one tax administration are involved. In few if any countries have the resources devoted to competent authority offices kept pace with the demands faced by those offices. Thus, the necessary and desirable involvement of the competent authority process always is likely to pose some limitations on the time reductions that are possible in negotiating APAs. However, since providing prospective certainty to companies on their pricing mechanisms is the objective of the program, countries that wish to participate in this process must commit to efficient and prompt resolution of the matters before them.

Another topic to be addressed in considering opportunities to improve the efficiency and timeliness of the APA Program is that of APA renewals. The renewal process for an APA should, in most cases, be more streamlined than the process of negotiating the initial APA because, absent material changes to the business operations of the taxpayer, the transfer pricing methodologies that were initially agreed upon often should be maintained in the renewal. The IRS charges a lower user fee for a renewal APA than an original submission, recognizing that the resource needs typically will be less. However, our experience, and the published timeline results in the APA annual reports, demonstrate that both the IRS and their foreign country counterparts continue to experience difficulty in timely processing APA renewals.

We think that renewals, more than most other kinds of cases, are likely to provide opportunities to test ways to streamline APA procedures. We therefore suggest that the APA Office take a careful look at the handling of renewals, and through that process seek to identify specific ways in which streamlined procedures could be implemented and developed, while at the same time explicitly maintaining the checks and balances that are built into the process.

Moving to another important topic, a cause of inefficiency in the processing of APAs and APA renewals has undoubtedly been a relatively high level of turnover within the APA Office. This problem is complex, and turnover not only in the APA Program

but in the IRS generally and, for that matter, throughout the government, always is likely to pose challenging issues. Nevertheless, improvements can be made.

In particular, we recommend that the IRS attempt to increase the number of career IRS appeals officers, international examiners, economists, and attorneys who serve a tour of duty within the APA program at mid-points in their careers. A good approach would be, through promotion and career development policies, to encourage such personnel with significant experience – say, typically, ten to fifteen years of experience – to serve three-to-four-year rotations in the APA Program. Management ranks within the APA Program should also include representation from such personnel. A rotation within the APA Program would, in particular, be useful background for IRS international technical specialists in the area of transfer pricing – a group that over time has contributed a great deal to transfer pricing administration, both in the APA Program and elsewhere within the IRS. In addition, because the APA process allows IRS personnel to gain insights into the operations of multinational enterprises, providing for rotational assignments of experienced IRS personnel to serve within the management ranks of the program would provide an excellent career development opportunity for later responsibilities at a senior executive level.

We would like now to conclude these comments by referring to a topic that has been prominent in the APA Program for some time – Case Plans and Schedules. These have been a part of APA Program procedures for a number of years, and we believe that Case Plans and Schedules should be serving an important role in facilitating timely completion of APA matters. In practice, however, it is our impression that IRS personnel, as well as taxpayers and their representatives, have not been maintaining the case plans and schedules with the rigor that was originally intended. We would call upon all involved in the process to reinvigorate their efforts to ensure that clear Case Plans and Schedules are agreed upon very early in the APA process, and that once these Case Plans and Schedules are agreed, all parties to the negotiations be held to compliance with these plans, with amendments made only in the event of clear and compelling unforeseen circumstances.

Again, we appreciate very much the opportunity to offer these comments. The APA Program is a good program and it adds greatly to tax administration, both in the United States and around the world. The program can, however, be improved, and we hope these hearings will prove useful in identifying and implementing necessary improvements.